The Commonwealth of Massachusetts
Department of Revenue
Leverett Saltonstall Building,
100 Cambridge Street, Boston 02204

L. Joyce Hampers
Commissioner

November 22, 1982

You inquire as to the Massachusetts income tax treatment of employee stock options which for federal purposes qualify as Incentive Stock Options.

Massachusetts General Laws Chapter 62, Section 2 provides that Massachusetts gross income is federal gross income with certain modifications. Massachusetts determines federal gross income according to the Internal Revenue Code as amended on November 6, 1978 and in effect for the taxable year ("1978 Code"). (M.G.L. c. 62, s. 1(c)). Massachusetts gross income is divided into Part A taxable income, which is taxed at the rate of 10%, and Part B taxable income, which is taxed at the rate of 5%. Part A income is composed of dividends, net capital gain and interest other than interest on savings deposits in banking institutions in Massachusetts. Part B income is all other income subject to taxation.

Under Section 421(a) of the 1978 Code, an employee does not recognize income on the grant or exercise of a qualified stock option if the holding period and definitional requirements of Section 422 are met. Upon the disposition of stock acquired through the exercise of the option and held for more than three years, the amount realized on the sale, less the option price is taxed as long-term capital gain. Option price means the price at which the stock subject to the option is purchased.

If stock acquired under a qualified stock option is sold within three years of acquisition, Section 421(b) of the 1978 Code controls the income tax treatment of the transaction.

The excess of the fair market value of the stock at the date the option was exercised over the amount paid for the stock is taxed as compensation at the time the stock is sold. Any additional profit is taxed as capital gain. (U.S. Treas. Reg. ss. 1.421-8(b), 1.422-1(b)).

Section 422, governing treatment of qualified stock options, applies to options granted after December 31, 1963 and before May 21, 1976, and to options granted after May 20, 1976, under plans existing prior to May 21, 1976, if exercised before May 21, 1981.

Section 83 of the 1978 Code governs the taxation of property transferred to an employee in connection with the performance of services. Under Section 83, which generally governs the treatment of non-qualified stock options, an option having no readily ascertainable fair market value when granted is taxed as compensation at the time the option is exercised. The amount taxable is the difference between the fair market value of the stock on the date the option is exercised and the amount paid for the stock. If an option has a readily ascertainable value when granted, the difference between the fair market value of the option when granted and the amount paid for the option is treated as compensation in the year the option is granted and no income is recognized on the exercise of the option.

An employee's basis in stock acquired through the exercise of a non-qualified stock option is the sum of the amount paid for the stock and the amount of income realized by the employee on the exercise or receipt of the option. Upon the employee's sale of the stock any further appreciation in value is capital gain.

Section 422A, which was added to the Internal Revenue Code by Section 251(a) of the Economic Recovery Tax Act of 1981 ("ERTA"), defines an Incentive Stock Option ("ISO") as an option granted to an individual for any reason connected with his employment by a corporation. An employee is not taxed when he is granted or exercises an ISO. When the stock received on the exercise of the option and held for the required period, one year, is sold the employee realizes capital gain income. Section 422A applies to options granted after December 31, 1980; Section 422A also applies to options originally granted after December 31, 1975 and exercised on or after or outstanding on January 1, 1981 if the corporation granting the option elects to have this section apply to the option.

You request rulings regarding the Massachusetts tax treatment of stock options in the following situations.

1. An employee exercised a stock option prior to May 21, 1981 which was originally granted as a qualified stock option under IRC Section 422. Subsequent to exercise of the option and before sale of the stock, the employer elected to treat the option as an ISO under the transitional rules of ERTA Section 251(c). The employee sells the ISO shares one year from the date of exercise and two years from the date of grant. For federal purposes the options are ISO's.

It is ruled that the employee has no taxable income for Massachusetts income tax purposes at the time of the grant or exercise of the option. Upon disposition of the stock prior to the expiration of the holding period in Section 422 of the 1978 Code, the difference between the amount paid for the stock and its fair market value on the date the option was exercised is Part B taxable income in the year of disposition. The employee's basis in the stock sold is increased by the amount of Part B income recognized. Amounts received in excess of basis are Part A income.

2. Same facts as (1) except that the ISO shares are sold more than three years from the date of exercise, thus meeting the holding period required of IRC Section 422(a)(1).

It is ruled that the employee has exercised a qualified stock option under Section 422 of the 1978 Code. He has no taxable income at the time of grant or exercise of the option. Upon sale of the employee's stock the difference between the amount realized on the sale and the amount paid for the stock is Part A income.

3. An employee is granted an ISO in 1982 under a new option plan meeting all the conditions of IRC Section 422A. The employee exercises the option in 1982. The shares are sold in 1984, meeting the holding requirements for ISO's.

4. An employee was granted a stock option in 1980 under a non-qualified plan. Prior to exercise, the plan and options were amended under the transitional rules of ERTA Section 251(c) and a valid ISO election was made by the employer. The ISO's were exercised in 1982 and the stock was sold by the employee in 1984, meeting the ISO holding period requirement.

With respect to (3) and (4) it is ruled that the employees have exercised non-qualified stock options. If the options had readily ascertainable fair market values when granted, the difference between the value of the option when granted and the amount paid for the option is Part B income in the year granted.

If the options had no readily ascertainable fair market values when granted the difference between the value of the stock on the date the option is exercised and the amount paid for the stock is Part B income in the year exercised. The employee's basis in the stock acquired through the exercise of the option is the sum of the amount paid for the stock and the amount of Part B income realized by the employee on the receipt or exercise of the option. Upon sale of the stock, the difference between the amount realized on the sale and the basis is Part A income or loss.

Very truly yours,

Commissioner of Revenue

LJH:MTD:RSF:mf

LR 82-110